10-1-1922

# Special bulletin no. 15 (1922, October); Capital stock; Public stenographer; Bonus; Bonus contract; Newsprint paper mill; Land company; Newspapers; Brokers; Moving expenses

American Institute of Accountants. Library and Bureau of Information

# American Institute of Accountants

## Library and Bureau of Information

OCTOBER, 1922. SPECIAL BULLETIN No. 15

**[The Committee on Administration of Endowment authorizes the publication of special Bulletins, of which this is one, on the distinct understanding that members are not to consider answers given to questions as being official pronouncements of the Institute, but merely the individual opinions of accountants to whom the questions were referred. It is earnestly requested that members criticise freely and constructively the answers given in this or any other Bulletin of this series.]**

---

### CAPITAL STOCK

Q. The Blank Corporation was organized with an authorized capital stock of 200,000 shares of no par value.

It issued 102,000 shares or 51% of the total authorization to a company for assets which exceeded the liabilities taken over by $550. A value of $9,450.00 was placed on the goodwill and the following entry passed:

| | | |
|---|---|---|
| Assets other than goodwill | 3,450 | |
| Goodwill | 9,450 | |
| To liabilities | | 2,900 |
| To capital stock | | 10,000 |

A certain promoter purchased the above 102,000 shares from the parties who owned the previous company and who had sold out to the new company for said 102,000 shares for $10,000 cash. The sale, while not affecting the corporation in any way, was the basis upon which the goodwill valuation was determined.

This promoter then made an agreement to purchase the remaining 98,000 shares at $2.00. In reality he was to sell them for what he could and turn over $2.00 for each share sold.

At the end of two months he had sold 3,000 shares and paid $6,000 to the corporation therefor.

The stockholders then held a meeting, procured authority from the State to change the capital stock to par value stock, a total authorization of 4,000,000 shares at a par value of $1.00 per share. They further decided to call in and retire all the no par value stock and issue to each holder of such 20 $1.00 par value shares for each one share of no par value stock held.

The promoter is, therefore, entitled to receive 2,040,000 for his 102,000 no par value shares and each other stockholder 20 to 1 also. The stockholders have paid the promoter anywhere from $2 to $20 for each no par value share, but the company has received only $2.00 for each share and has no knowledge of what each stockholder has actually paid the promoter for his no par value stock.

In setting up the par value stock given in exchange for the no par value shares, what account is to be charged? In other words, take an example, the promoters own 102,000 no par value shares. In this case capital stock account shows a credit of but $10,000 as the actual value received for these shares. Now the capital stock should show a credit of $2,040,000, or $2,030,000 more than now appears to its credit. What can be done, or, what account can be debited with $2,030,000?

**We believe the transaction represents a fraudulent issue of stock. No value will be received for the 2,030,000 shares as well as the additional shares to be received by the other stockholders who have paid the promoter less than $20.00 for the no par value shares purchased.**

As it is, therefore, in our opinion impossible to make a proper entry to cover the issue of the par value stock in exchange for the no par value shares, what would you advise this corporation to do in order to save itself from future difficulties and to enable it to draw up a proper balance-sheet at this time?

A. It would appear that after the corporation had issued 102,000 shares of stock, no par value, it placed a valuation of $10,000 thereon, that being the equity of the stockholders after taking into account as an asset goodwill, valued at $9,450.00. The disposition of $10,000.00 cash, received for the 102,000 shares, is not disclosed.

If we regard the second transaction with the promoter as not a sale, but a roving commission to attempt to sell 98,000 additional shares, paying the company $2.00 for each share, apparently the corporation at the end of two months would show a capital stock valuation of $16,000.00, representing 105,000 shares of no par value stocks. This assumes that there is neither loss nor profit during the two months' period. Assuming also that, for illustration, we may build up a balance-sheet based on the original statement, the adjusted balance-sheet would be as follows:

| | | | |
|---|---|---|---|
| Current assets | $9,450.00 | Liabilities | $2,900.00 |
| Goodwill | 9,450.00 | Capital stock—105,000 | |
| | | Shares of no par value | 16,000.00 |

This gives each share of no par value stock a value of 15.2 cents, assuming that the goodwill could be realized at its face value.

We are reluctant to follow the proceedings to the point of valuing 105,000 shares at the exchange of $20.00 per share par value or $2,100,000, and suggesting a form of balance-sheet based thereon. If the question submitted covers all the facts, our advice, as requested in the last paragraph, would be that the company come down to earth, and adjust its capitalization to a reasonable relation to its apparent business.

The issue of 105,000 no par value shares, in itself, seems altogether disproportionate to the net asset value shown by the balance-sheet; the resolution to exchange each no par value share for 20 shares of a par value of $1.00 each results in a capitalization so preposterous as to suggest that some factor in the situation is not disclosed in the question.

## PUBLIC STENOGRAPHER

Q. What is the ratio of the expenses of a public stenographer as compared to the income? That is, what part of each dollar received by a public stenographer should be paid for employees, for rent, for advertising, etc., so that a profit could be made?

A. There are two kinds of public stenographers—1st: The reporting stenographer, exemplified in some states by the certified shorthand reporter, who does not take dictation ordinarily, nor do typing work. 2nd: There is the public stenographer who takes dictation, such as letters, memoranda, briefs, etc.

As to the first—the expense for typing is about one-third of the gross amount received by the stenographer for the job. Comparatively few shorthand reporters employ typists by the week. The typing work is usually contracted for and cost varies according to the number of copies. It is safe to say one-third for typing is correct. In addition to this, there are the usual office rent and telephone. There is no expense for paper or carbon, as the typist furnishes these.

As to the second class, the cost depends upon the amount of business in the office. For example, some copying offices have as many as fifteen or twenty stenographers and typists, some doing only typing and others both. An office of this kind, I should say, will earn fully 50%, and this takes into account all overhead charges, such as cost of paper, carbon, repair of machines, rent and telephone.

My own work as a certified shorthand reporter has been somewhat out of the ordinary for the past ten years, being devoted almost wholly to legislative reporting. In many cases I have furnished up to one hundred copies, the highest number, down to about forty copies; in some instances about ten copies. Of course, where I furnish forty to one hundred copies the work is mimeographed and is done in relay form. This requires the highest class of reporting, and stenographers receive seventy-five cents per page net, the typists (who write on a wax stencil) receive twenty-five cents per page, and to this should be added the cost of running on the mimeograph twenty-five cents per page, and in addition the cost of paper, ink, separating, binders and delivering. It is fair to say the total cost is $1.50 per page.

## BONUS

Q. A client of our office told us today that he wished to pay a bonus to a certain group of employees. He said the bonus was to be 10% of the audited net profits for 1921 after deducting:

(1) The bonus.
(2) Federal income and excess profits tax for 1921.
(3) New York State franchise tax (4½%).
(4) A reserve of $500 to take care of Federal capital stock tax.
(5) A reserve of $6,000 to take care of possible back taxes.

The bonus to be used, of course, in computing taxes. The audited net profits for the year amounted to $205,600.26. Invested capital to be used, $342,420.51.

A. This solution is subject to the following assumptions:

(1) That the net audited profits are not subject to deduction for New York State taxes paid in 1921. No mention was made as to the amount of these taxes, and as the New York State tax shown in the computation does not become a liability of the corporation until the year 1922, no deduction of that amount has been made before determining the federal income and profits tax. A correct solution of this problem could only be made by taking into account New York State taxes paid in 1921. These taxes are deductible from income for federal income and profits tax purposes.

(2) That the problem has been correctly stated when it provides that the employees shall receive a bonus of 10% of the net earnings after deducting, among other items, the bonus. As this phase of the problem really means that the employees are to receive 9% of the profits after the other deductions are made it seems absurd to state that they are to receive 10% of such profits.

It is assumed that the reserve of $500.00 for capital stock tax, is that which will attach as a liability in June, 1922.

Reserves for contingent expense such as is the "Reserve for back taxes" are not deductible for tax purposes.

| | | | | |
|---|---|---|---|---|
| Net audited profits | | | | $205,600.26 |
| Bonus of 10% accruing to employees | | | | 10,660.85 |
| Taxable income | | | | 194,939.41 |
| New York State franchise tax | | | $8,772.27 | |
| Federal income and profit taxes | | | | |
| Excess profits taxes | | | | |
| Excess profits credit | | | | |
| 8% of inv. cap. | $27,393.64 | | | |
| Specific exemption | 3,000.00 | | | |
| Total E. P. credit | 30,393.64 | | | |
| 20% of inv. cap. | 68,484.10 | | | |
| Taxable @ 20% | 38,090.46 | $ 7,618.09 | | |
| Remainder of income Taxable @ 40% | 126,455.31 | 50,582.12 | | |
| Total excess profits tax | | 58,200.21 | | |
| Income tax | | | | |
| Taxable income | 194,939.41 | | | |
| Less E. P. tax | 58,200.21 | | | |
| Taxable @ 10% | 136,739.20 | 13,673.92 | | |
| Total federal tax | | | 71,874.13 | |
| Total taxes | | | 80,646.40 | |
| Net audited profits | | | | $205,600.26 |
| Less reserve for capital stock tax | | | 500.00 | |
| Less reserve for back taxes | | | 6,000.00 | 6,500.00 |
| | | | | 199,100.26 |
| Less federal and state taxes | | | | 80,646.40 |
| | | | | 118,453.86 |
| 10% deduction before dividing with employees | | | | 11,845.39 |
| Net profit subject to bonus | | | | 106,608.47 |
| Bonus 10% of above amount | | | $10,660.85 | |

## BONUS CONTRACT

Q. A company has a contract with its manager, which stipulates that the manager is to receive a bonus of 20% of the net profits above a certain fixed amount. Assuming that the net profits of the company before deducting the manager's bonus was $60,000 for 1920 and $40,000 for 1921, what would be the amount of bonus to be paid in the two years provided the manager was to receive 20% of the annual net profits in excess of $25,000.

No question of federal taxes is involved, but the point has been raised as to the propriety of deducting the 1920 bonus from the net profits of 1921 in computing the 1921 bonus.

Also, should interest received on bonds owned by the company be included in the net profit upon which the bonus is computed?

A. There does not seem to us to be any justification for treating the bonus paid in respect of the operations of one year as a charge against the profits of the succeeding year. We know of no case in which such a contention has even been advanced.

In regard to the second inquiry, whether interest received on bonds owned by the company should be included in the net profit upon which the bonus is computed, we think the answer depends on the precise terms of the contract. The question states that the manager is to receive a bonus of 20% of the net profits above a certain fixed amount; the term "net profits" clearly requires further definition. If the contract itself is not clear on the point the way in which the fixed amount is determined probably throws some light upon it. If, for instance, the fixed amount were a percentage on the entire capital and surplus invested in the business, it would be natural to bring into account all income of the business from whatever source. If, however, the fixed amount were a definite return on the capital of the company and the bonds represented an investment of the company's share of the profits in previous years which had not been distributed, it would be entirely equitable to exclude the interest on such bonds in arriving at the sum on which the manager's commission would be computed.

## NEWSPRINT PAPER MILL

Q. I wish to get an opinion whether or not spoiled material should be included as an element of cost where the circumstances are as follows:

A newsprint paper mill had a contract to sell paper during the six months period ended December 31, 1920, on the cost-plus basis. The contract reads as follows:

> "Production costs are to be determined as follows: The actual cost of ground wood, sulphite, alum, color, sizing, and all other materials which become a part of the paper purchased during the six months ending December 31, 1920, shall be added to the inventory value as of June 30, 1920, and from the total amount thus obtained the inventory values of corresponding items at December 31, 1920, shall be deducted. To this amount shall be added the direct conversion or manufacturing costs, including labor, power, lubricants and all other customary expenses of operating and maintaining the paper mill property with $2.00 per ton of paper as depreciation of buildings and equipment, actual cost of all insurance and all other charges for local property taxes and federal capital stock taxes, but exclusive of income taxes and excess profit taxes. The costs shall also include wrapping and finishing and selling, administration and general expenses, as shown on the books of the company. Salaries of officers and managers are to be included at $1.85 per ton for all paper manufactured."

The paper mill does not have a cost system. The cost on this contract was figured on the basis of the percentage of the tonnage shipped to the customer, to the total newsprint produced during the period. For instance, if the total quantity of newsprint manufactured during the period was 10,000,000 pounds, and the total cost was $800,000, the unit cost would be $8.00 per one hundred pounds. If the customer got 7,000,000 pounds of the 10,000,000 produced the cost to the customer would be $560,000, to which cost would be added the profit of $70,000, which is one cent per pound on the paper shipped the customer as provided for in the contract.

During the latter part of the period of the contract 350 tons of groundwood pulp in the warehouse was damaged in such a way as to make it impossible to use it, by some organic growth, of course through no fault of the paper mill management. Ordinarily this pulp, which had cost $35,000, could have stayed in the warehouse eight or ten months longer without showing any signs of spoilage.

Approximately two-thirds of the newsprint produced during the period was shipped on the contract, and it is the contention of the paper mill that the customer should stand his proportion of the cost of the spoiled pulp, while the customer contends that he should not stand any of the cost of the spoiled pulp.

A. It appears that if the total cost during the period involved was $800,000 and the estimated cost of $8 per 100 pounds was based on an output of 10,000,000 pounds, and that such cost per 100 pounds did not include the element of spoilage, this cost per 100 pounds would be somewhat increased when the discovery was made that 350 tons of ground-wood pulp had become damaged so as to make its use impossible, because of the fact that the total number of pounds produced during the period would be decreased.

It would seem proper to calculate the cost per 100 pounds for the period by dividing the total cost of $800,000 by the actual number of pounds of good paper resulting from the operations. The cost of paper delivered to the customer in question should then be determined by taking the number of pounds delivered at the correct cost per 100 pounds, based on the whole period of operations. The effect obviously would be to include in the cost to the customer the element of spoilage.

Such a procedure would, of course, call for an adjustment in the settlement between the mill and the customer which, however, is not part of the problem submitted by you.

## LAND COMPANY

Q. Our firm is now engaged on the audit of a land company, whose main operations consist of the sale of building lots. This concern, some thirty years ago, acquired three large tracts of undeveloped ground. Contrary to the ordinary usage in these cases, when money was expended for improvements and betterments, the amount was not charged—as it should have been—to the respective tracts, but was immediately charged out as an operating expense. When these lots were sold, the gross amount of the sales was credited to the tracts. The results of these entries is that at this time when perhaps three-quarters of the tract have been sold, the remaining quarter stands on the books at a ridiculously low valuation.

As our audit only goes back a period of five years, and as it is to all intents and purposes practically impossible to trace back the entires for 30 years, would it not be the proper thing to do to inventory the unsold portion of these tracts at what would be considered a conservative value?

Of course, it must be well explained that it is difficult to place a market value or price at which similar lands could be purchased today in large amounts, but we can, with a degree of conservatism, arrive at a valuation, which, upon resale, would yield something like 100 per cent. gross profit, and this is the figure that we had thought of using.

The difficulty which confronts us at this time is that this concern has been sending statements to the stock exchange year after year, showing a surplus which is very much underestimated, and, of course, if we on our balance sheet undertake to set up the value of these lands at anything like a fair price, it will automatically increase the surplus from some two hundred and fifty thousand up to a million, and we naturally realize the seriousness of the situation, as no doubt this statement will have a material influence on the value of this stock on the exchange.

Of course, it is understood that we will qualify our balance sheet on the subject of land values, stating that the amount is not the book value but an appraised value, and we can get the president of the company as well as the secretary and perhaps the chairman of the executive committee to certify to the fact that the land is well worth the appraised valuation used. Our report will also suggest that an expert appraisal be made of these lands.

We are, of course, troubled on the one hand by the fact that our balance sheet will greatly enhance the value of the stock on the open market, but on the other hand, we are not forgetting that the stockholders are entitled to know the truth with respect to this land, and it is our humble opinion that this method will more clearly reflect the true condition than if we were to attempt to analyze the tract account with the limited material at our disposal.

A. We think there is certainly no obligation on the auditors to go back over the accounts of the thirty years' operations with a view to restating the unsold land at a correct figure. Apart from the question of taxation we think it would be entirely in order for the auditors to accept the value of the lands at the commencement of the period covered by their audit, applying correct principles to the transactions since that date and stating in their report or certificate that they have accepted the opening balance and are satisfied that it was less than the fair market value of the land. It would appear, however, that for tax purposes a valuation at March 1, 1913, and correct treatment of the accounts since that date are essential. We think the auditors might, in the circumstances, adopt the same basis for general acounting as for tax purposes. We should not be disposed to advise the auditors to place their own valuation on the unsold land, however conservative their valuation might be. If any appraised value is to be used we think the responsibility therefor should be placed on the officers of the company or on qualified experts employed by them.

No doubt the auditors are alive to the possibility of a qualification regarding tax liability being necessary as a result of the unsound accounting methods as well as a qualification as regards the understatement of the remaining land values.

## NEWSPAPERS

Q. The following is quoted from "Auditing" by L. R. Dicksee, and edited by R. H. Montgomery, 1908, p. 70, which explains what I mean by establishment account.

> "Every periodical is started at a loss, and it is usual to debit this loss to an establishment account; when the concern pays—and so acquires a goodwill—the cost of such goodwill is represented by the amount to the debit of establishment account, which thus virtually becomes a goodwill account. There is no great objection to this system, and it is much in favor on account of the information it affords to the intending purchaser of a recently established paper; but, when a periodical is once fairly started, the auditor should require a very good reason to be furnished him before he sanctions the transfer of an unexpected loss to the establishment account; if such a loss arises from an increase of matter (in quantity or quality) or a reduction in price, it may be in the nature of capital outlay, as tending to increase the permanent value of the concern, but an unexpected loss is likely to have the contrary effect."

If a newspaper during its first year lost $20,000 and during that year secured four thousand subscriptions, would it be proper to capitalize these subscriptions at say, $5.00 each, which would consume the entire amount of loss in establishment account?

What I am anxious to know is how establishment account values are determined, i. e., if there is any fixed practice with reference to handling of said account.

A. We have your inquiry concerning a question referred to the Bureau of Information as to how "establishment values" are determined for newspapers and we also note the quotation from Dicksee's "Auditing."

In reply we may say that this quotation fully covers the principle, It would seem therefore that the entire loss incurred by a newspaper up to the time that it should be on a paying basis may be capitalized. There is no fixed method of determining the length of the establishment period but the capitalization of the first year's loss as the cost of establishment does not seem unreasonable.

## BROKERS

Q. A member of the New York Stock Exchange, in addition to conducting his brokerage business, is an active trader on his own account. His own open trades, long and short, at most times embrace as many as 50,000 shares of stock and substantial values in bonds; all of these open trades have been entered into purely for trading purposes, not for investment. We understand that the practice described is quite general and would like very much to know the prevailing opinion as to whether these open trades, both long and short, should be adjusted to market values for the purposes of stating the trader's financial position at a given date and the results of his trading operations for a given period, or whether the long trades should be inventoried at cost and the short trades at sale prices until the transactions are closed by sale or purchase. The position of the bureau of internal revenue seems fairly well settled, and our interest in the matter is more from the independent standpoint of good accounting practice than from that of applying the income tax laws.

A. We have received the following answer to your question:

In our opinion a member of the New York Stock Exchange who, in addition to conducting his brokerage business, is an active trader on his own account and has open trades, both long and short, should adjust to market values both the long and short open items for the purposes of stating his financial position at a given date and the results of his trading operations for a given period. This practice, we believe, is general where the transactions are entered into for the purpose of profit and not for permanent investments.

If the securities do not have a ready market value or are carried as investments, or if it is desired to present a very conservative balance sheet, the securities should be valued at cost or market, whichever is lower. In other words, the losses are taken into account but no profits are included until actually realized by sale.

## MOVING EXPENSES

Q. To obtain increased facilities for future operations a corporation leases a new factory site and building. Should the expense of moving from the old location to the new location be treated as a deferred charge to operations and written off over a period of years, or written off entirely in the year in which it was incurred?

A. In our opinion the expense of moving from the old location to the new location may be set up as a deferred charge to operations if considerable, and written off over the period of the new lease not to exceed five years.